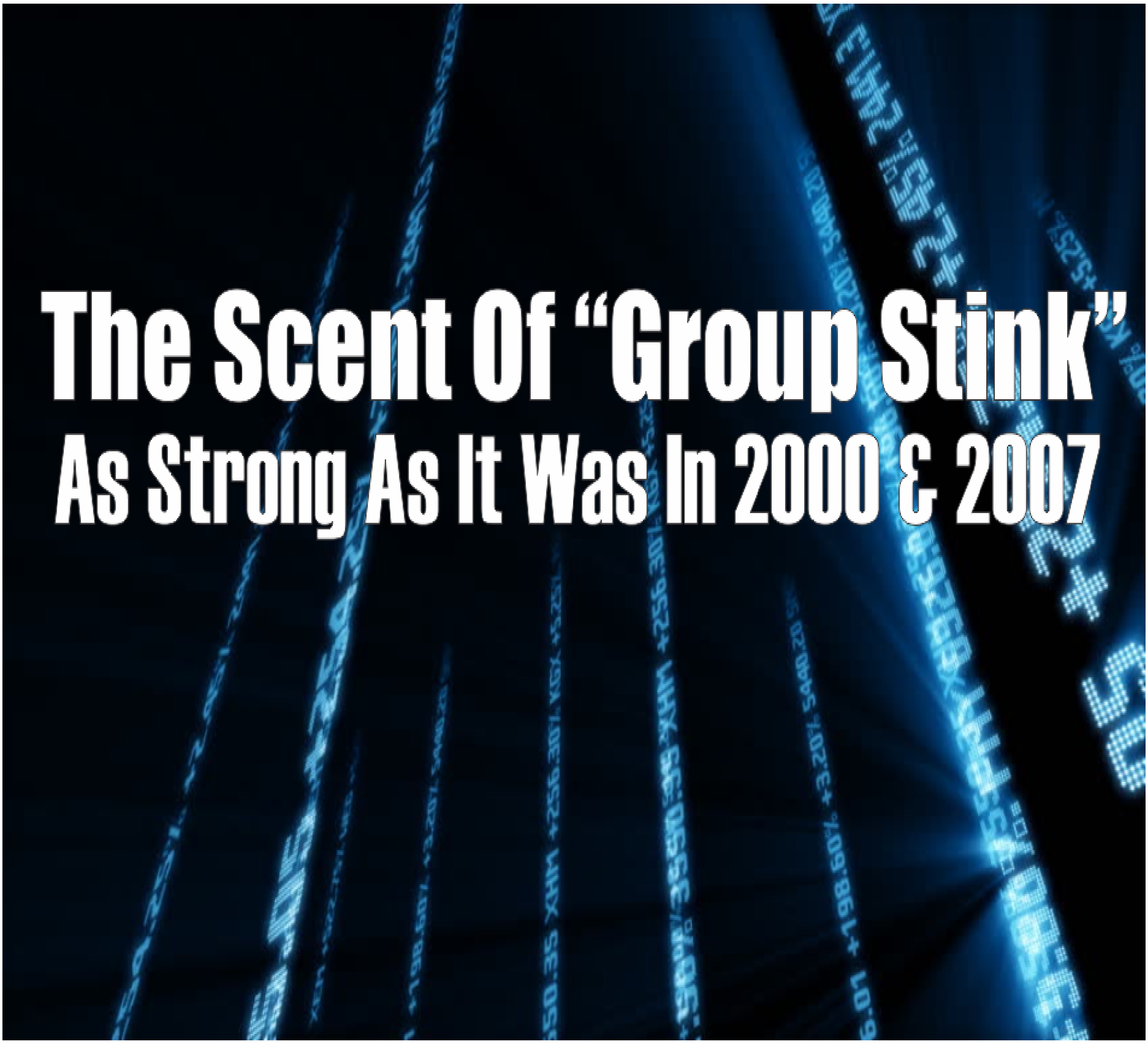

By Doug Kass

> ** In a paperless and cloudy world, are investors and citizens as safe as the markets assume we are?•--Kass Diary*

Another provocative missile launched by North Korea and another apparent terrorist attack in London, England, are, once again, overnight and early-morning features of our reality as investors and as citizens. The S&P futures fell a meaningless four handles from the time of the events, indicating even the machines and algorithms couldn't care less about much of anything impacting equities!

> *"Nothing succeeds like success."•-Alexandre Dumas*

"Group stink" runs thick these days, as Dumas, a 19th century French writer, noted. To this

observer, our markets' resilience is all too reminiscent of former Citigroup CEO Chuck Prince, who kept on dancing because the music was still playing. To me, the indomitable market is more a function of lemming-like behavior in a market, economy and profit setting that is far less secure and strong than many subscribe to. Group stink is a powerful force in the markets, especially when the machines and algorithms and the ever-constant inflows into popular passive funds and ETFs dominate the investment backdrop. These factors exacerbate short-term trends and may contribute to the perpetuation of an ill-conceived perception of a daunting and inexhaustible virtuous market cycle. Golfer Tom Watson once wrote, "Sometimes thinking too much can destroy your momentum." And most investors and traders, in a reactionary mode, seem to prefer to adopt such a strategy. But, I vividly remember the positive and incessant price momentum in early 2000 and late 2007 that appeared impossible to divert until, all at once, an important change in price trend occurred, seemingly overnight. The market consequences were ugly. There is now a near-universality of view that stocks will move higher and that any dip is to be bought. Even the threat of a potential nuclear attack now brings on a market yawn. The one-way action and lack of volatility have resulted in some of the greatest hedge-hoggers giving back tons of money (e.g., Seth Klarman's Baupost) and/or closing down completely (as chronicled here•andhere.) If some of the greatest minds can't deliver alpha, we possibly should consider that things have gone awry and think about accepting something that Grandma Koufax used to say: "*Dougie, something is rotten in Flatbush."* As I recently wrote in "The Market Band Plays On, But You Won't Catch Me Humming Its Mindless Tune":

> *Throughout the last six months I have expressed the view that the S&P 500 Index was in the process of making an important top and that risk was being underpriced. Throughout the last month I have grown more bearish than I have been in several years. That negative outlook is reflected in the extreme condition that, beyond indirect holdings in my hedge fund, I am in the unique position of owning no individual equities in my personal account. That's a statement of conviction in view.*

In "Dark Conditions Totally Eclipse Anything We've Seen in Decades" I outlined my concerns:

> **** Markets**: The dominance and popularity of passive investing -- most notably ETFs and volatility-trending and risk-parity strategies -- are relatively new to the market's picture. I contend that the lack of price discovery from these influences may have spoiled stock charts and partially ruined the ability of some to rely on technical analysis. * **Valuations**: Most valuation metrics are at least in the 95% decile, an occurrence that typically has coincided over history with the end of maturing bull markets or in the ninth inning of speculative eras. * **Corporate Profits:** With the largest spread between GAAP and non-GAAP earnings in history, never has such liberal use of accounting standards been accepted by the masses of market participants. * **Central Banks**: With $19 trillion ($1.5 trillion added in 2017 alone) in central bank assets, monetary authorities never have had such influence as they have in the past few years. Like quantitative strategies, the outsize role of central banks is new and its impact is great. It also has diminished price discovery. As I recently wrote, the "Debt Opioid Addiction Could Turn Ugly Fast." * **Economic:** As the years go by it is increasingly clear that, despite the unprecedented role of central bankers reducing interest rates, secular global growth prospects have been reduced relative to the last several decades. Moreover, The Screwflation of the Middle Class has resulted in an income and wealth gap that has not improved over the last three to five years. * **Politics:** The Orange Swan is a new factor, as articulated here and here. Like him or hate him, President Trump is unlike any POTUS in history. Another aspect of politics that is different is the degree of animus in Washington, D.C. There has never been such partisanship. Ever. * **Geopolitical**: Markets have never*

been as exposed to such geopolitical acts and risks. Specifically, it has been 53 years since we faced a nuclear risk.

Respectfully, unlike some others, I belief the cause of the recent market indigestion -- and possible future market drawdowns -- likely has very little to do with seasonality or the month of August, nor will it likely be a function of the historical weakness often seen in September and October. The market's issues run deeper and my concerns are based on both technical and fundamental grounds. They have to do in part with the uncertainty surrounding various political, geopolitical, economic, market and monetary policy issues, many of them with potentially adverse outcomes. At least to me, the macroeconomic does impact Bristol-Myers Squibb (BMY) and Amazon (AMZN) and General Motors (GM) . My concerns also have to do with the message of the bond market (this morning, the yield on the 10-year U.S. note is down by nearly five basis points to 2.11%), which indicates to me that the trajectory of domestic GDP growth and corporate profits is likely to disappoint for the fourth consecutive year. Further adding to my concerns is the role of passive investing as the dominant influence on the markets. ETFs that rebalance daily and quantitative strategies such as volatility trending and risk parity exacerbate short-term moves and are, too often, the tail that wag the market dog. As I have asked, if the machines decide to sell, who is left to buy? In part, these strategies have elevated valuation metrics above the 95% decile, alarming far too few market participants. Unfortunately, markets that are priced to perfection are vulnerable to exogenous shocks such as an Orange Swan, a missile aimed at Japan, a severe hurricane or a monetary policy mistake. Meanwhile, there were technical breaks developing, starting with the outsize performance gains from the anointed FANG stocks. These conditions also were generally ignored by the bullish cabal. Group Stink has ruled the day -- a condition often seen historically at or near market tops. As I have written, the thing to fear is the lack of fear itself. Few commentators and talking heads in the business media, many of whom counseled the lemmings who stood strong in equities in both early 2000 and late 2007, have been willful participants in the Bull Market in Complacency and have contributed to the potential of a Minsky Moment. My bearishness also reflects my view that the business cycle is mature and that there are Peaks Everywhere. Most notably, low interest rates have pulled forward sales in various sectors. Industries such as housing, where affordability again has been stretched, and autos, where the cycle has peaked, are samples of my concerns. Meanwhile, the retail industry has been eviscerated, with ugly consequences for real estate and employment, by a Dark Star named Amazon, a recent target of my disaffection. Nearly three weeks ago on Aug. 10, I wrote "To Heck With the Crowd, I Remain Manifestly Bearish," which underscored my multiple concerns (as they specifically relate to North Korea, see my boldfaced first question below that gnaws at me every morning). It stated in part:

> *"I won't tell you that the world matters nothing, or the world's voice, or the voice of society. They matter a good deal. They matter far too much. But there are moments when one has to choose between living one's own life, fully, entirely, completely - or dragging out some false, shallow, degrading existence that the world in its hypocrisy demands. You have that moment now. Choose!" --Oscar Wilde*

Sometimes you need to sit alone on the floor in a quiet room in order to hear your own voice and not let it drown in the noise of others. I am sitting on that floor now, and thinking -- and shorting more. Too many traders and investors think they know what will happen in the markets. They establish one, specific price target, usually clothed in certainty. But the most successful traders and investors work with probabilities of outcomes. I continue to maintain a historically high net short exposure because I believe we face numerous political, geopolitical, economic and market outcomes that could end badly -- very badly. After yesterday's "fire and fury" ("TV-tough") statement by President Trump regarding North Korea, I repeated five of my concerning questions:

> **** In a paperless and cloudy world, are investors and citizens as safe as the markets assume we are?*** ** With the G-8's geopolitical coordination at an all-time low, how slow and inept will the reaction be if the wheels do come off? * Remember when the big argument in favor of President Trump was that he was a dealmaker who knew how to get things done? That was when he was doing real estate deals. Now he has to deal with 535 other politically partisan legislators in Congress on their own real estate turf. * Does the administration have the depth of experience, understand the extent of the legwork and organization required for passing legislation, or have a coherent idea or shared vision of what it wants to achieve and what problems it means to solve? * If President Trump can't easily put through a health care package, what does that mean for more difficult regulatory reforms and his tax and fiscal policy?*

I then repeated my top 10 market concerns. ***Bottom Line***

> *"I wanted a perfect ending. Now I've learned, the hard way, that some poems don't rhyme, and some stories don't have a clear beginning, middle, and end. Life is about not knowing, having to change, taking the moment and making the best of it, without knowing what's going to happen next. Delicious Ambiguity." --Gilda Radner*

Market views are like noses -- everyone seems to have one! To me, investors are complacent, numerous outcomes of all breeds (many of them adverse) seem possible, the business cycle is mature, machines and algorithms have undue market influence (and if the movie goes into reverse, selling rather than buying remains an existential market threat), valuations are at an historical extreme and thus make markets vulnerable to external shocks, and the market's technical condition has been deteriorating for months. And, in 2017, our interconnected, flat and networked world is unsafe on numerous fronts. And, as I have expressed, after a lengthy period of quiet, volatility and uncertainty are likely to be great again.I plan to continue to err on the side of conservatism and I continue to maintain a skeptical view of the market's reward compared to risk and the limited upside relative to downside. But, as described in "Fearlessly Make Uncertainty and Volatility Your Friends!," I also intend to capture alpha by being opportunistic, both from a trading and investing perspective. *** As it is said, we live in interesting (and challenging) times, influenced by a set of relatively new circumstances and actors that have led to a *Bull Market in Complacency* -- and the risk of a *Minksy Moment* -- in which numerous outcomes, many of them adverse, are possible. Today, as I did in early 2000 and in the late summer of 2007, I pay heed to Woody Allen, who said:

> *"More than any other time in history, mankind faces a crossroads. One path leads to despair and utter hopelessness. The other, to total extinction. Let us pray we have the wisdom to choose correctly."*

Be alert, consider the contrary and think about sitting out some of the market's dances, perhaps before your legs are chopped off.